Supreme Court, U.S.
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No. 97 • 511

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1997

RHOADES OIL COMPANY

Petitioner,

v.

THE UNITED STATES OF AMERICA

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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September 17, 1997

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10 PP

QUESTION PRESENTED

Did the Tenth Circuit Court of Appeals violate this Court's rulings, reaffirmed most recently in *Commissioner v. Schleier*, 115 S.Ct. 2159 (1995) and *United States v. Burke*, 112 S.Ct. 1867 (1992), that exclusions from gross income are available only if specifically stated and that such exclusions must be narrowly construed, when the Tenth Circuit ruled that the lifting costs of an oil and gas business are excluded from its gross income because such lifting costs are analogous to costs of goods sold which are excluded from the gross income of a manufacturing, merchandising, or mining business under 26 C.F.R. §1.61-3(a)?

LIST OF PARTIES

Petitioner and Respondent are named in the caption and were the only parties to this case before both the Tenth Circuit Court of Appeals and the United States District Court for the Northern District of Oklahoma.

RULE 29.6 STATEMENT

As required by Rule 29.6 of this Court, Petitioner, which is a Delaware corporation, states that it has no parent company or nonwholly owned subsidiaries.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1997

RHOADES OIL COMPANY

Petitioner,

v.

THE UNITED STATES OF AMERICA

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Rhoades Oil Company ("Petitioner") asks this Court for writ of certiorari to review the June 19, 1997, Order and Judgment of the United States Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The Tenth Circuit's opinion below is an unreported Order and Judgment filed on June 19, 1997. A-1.[1] In that opinion, the Tenth Circuit reversed an Order of the United States District Court for the Northern District of Oklahoma filed February 15, 1996. A-4. The District Court had granted summary judgment to Petitioner in a suit for refund to recover personal holding company taxes and interest assessed against and paid by Petitioner for the tax years 1988, 1989, and 1990. Pursuant to the February 15, 1996 Order, Judgment was entered in favor of Petitioner and against Respondent in the District Court on February 20, 1996. A-26.

JURISDICTION

The Tenth Circuit Court of Appeals filed its Order and Judgment on June 19, 1997. A-1. Jurisdiction lies under 28 U.S.C. § 1254(1) for this Court to review the final decision of the Tenth Circuit Court of Appeals. This Petition for Certiorari is filed under Rule 13.1 of this Court.

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[1]The Appendix to this petition is cited as "A-_____."

STATUTES AND REGULATIONS

This case involves the following statutes and regulations, all of the relevant portions of which are fully reprinted in the Appendix due to their length: Statutes - 26 U.S.C. §§ 61(a)(2), 162, 471, 542(a), 543, and 613; Regulations - 26 C.F.R. §§ 1.61-1(a), 1.61-3(a), 1.471-7, 1.471-8, 1.613-3, 1.613-4(a) and (f), and 1.614-3(e).

STATEMENT OF THE CASE

This case concerns the amount of gross income of an oil and gas business. This case is unusual in that the usual roles of the taxpayer (Petitioner) and the government (Respondent) are reversed: Petitioner asks this Court to determine that its gross income is higher, while Respondent seeks a ruling that Petitioner's gross income is lower. This is due to the fact that this case involves personal holding company taxes, which are assessed when a taxpayer's "personal holding company income" exceeds sixty percent of its "adjusted ordinary gross income." 26 U.S.C. §543(a).

Respondent calculated Petitioner's gross income[2] by excluding Petitioner's "lifting costs," which are the costs of labor, repair, maintenance, materials, supplies, property taxes, insurance, and severance taxes incurred to operate and maintain oil and gas wells.[3] Using the calculation of gross income put forth by Respondent, Petitioner met the test under 26 U.S.C. §542(a)(1) and was assessed personal holding company taxes.

Petitioner disputed Respondent's calculation of its gross income, and unsuccessfully appealed the assessment under the Respondent's internal procedures. Petitioner then paid the taxes and filed suit for a refund in the United States District Court for the Northern District of Oklahoma. Jurisdiction in the court of first instance was pursuant to 28 U.S.C. §1346(a)(1).

The matter was submitted to the District Court on cross motions for summary judgment based on stipulated facts and upon the deposition testimony of one expert witness sponsored by Petitioner. Petitioner's expert witness testified that an oil and gas business such as

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[2]Gross income is the starting point for the determination of a taxpayer's "adjusted ordinary gross income." 26 U.S.C. §543(b)(1).

[3]Lifting costs are also sometimes referred to as "lease operating expenses." The terms are synonymous.

Petitioner does not have "costs of goods sold" and that Petitioner's lifting costs were not the same as or comparable to costs of goods sold. This evidence was not rebutted by Respondent. A-69 . The sole issue presented to the District Court was whether lifting costs should be excluded from Petitioner's gross income in determining if Petitioner was subject to personal holding company taxes.

The District Court ruled in favor of Petitioner, rejecting the argument of Respondent that 26 C.F.R. § 1.61-3(a) applied. A-4. The District Court held that 26 C.F.R. §1.61-3 on its face applies only to a "manufacturing, merchandising, or mining business" and that the Petitioner is an oil and gas business. The District Court noted that the oil and gas business is not within the meaning of "mining" under the Internal Revenue Code. The District Court ruled that because there is no statutory or regulatory exclusion from gross income for the lifting costs of an oil and gas business, Petitioner's gross income must be calculated without such an exclusion. With Petitioner's gross income calculated without the exclusion of lifting costs, Petitioner was not subject to personal holding company taxes, and was entitled to a refund of the taxes paid.

The Tenth Circuit Court of Appeals reversed the District Court, stating that it was "persuaded that lifting costs are analogous to costs of goods sold" and that

therefore the reasoning of 26 C.F.R. §1.61-3(a) applied. A-2. The Tenth Circuit stated that "the general rule is that "'gross income' means the total sales less the costs of goods sold[,]" and then implied that 26 C.F.R. §1.61-3(a) merely applied this general definition to manufacturing, merchandising, or mining businesses. A-2. However, the Tenth Circuit cited no authority for the "general rule" on which it relied.

REASON FOR GRANTING CERTIORARI

This Court should grant certiorari because the decision of Tenth Circuit Court of Appeals violates the long line of cases in which this Court has consistently held that an item is included in gross income unless there is a specific exclusion available, and that all such exclusions from gross income must be narrowly construed. *Commissioner v. Schleier*, 115 S.Ct. 2159, 2163 (1995); *United States v. Burke*, 112 S.Ct. 1867, 1870, 1878 (SOUTER, J. Concurring at 1878) (1992); *Commissioner v. Glenshaw Glass Co.*, 75 S.Ct. 483, 475, 477-78 (1955); *Commissioner v. Jacobson*, 69 S.Ct. 358, 369 (1949). Instead, the Tenth Circuit broadly construed the exclusion from the gross income of a manufacturing, mining, or merchandising business for costs of goods sold, contained at 26 C.F.R. § 1.61-3(a), to apply by analogy to exclude the lifting costs of an oil and gas business from its gross income. There is no specific exclusion stated anywhere in the Internal

Revenue Code or the Internal Revenue Regulations that requires the exclusion of lifting costs from the gross income of an oil and gas business. The Tenth Circuit opinion decided this federal question in a way that is in conflict with applicable decisions of this Court. See, S. Ct. Rule 10.1(c).

The writ of certiorari is needed to safeguard the integrity of this Court's holdings that the only exclusions from gross income available are those that are specifically stated, and that the exclusions that are available must be narrowly construed. This Court has repeatedly emphasized these principles in a line of cases that spans over forty years, including the *Jacobson* case in 1949 and the *Glenshaw Glass* case in 1955. The Respondent has successfully argued before this Court on three occasions in the last five years that exclusions from gross income must be narrowly construed. *O'Gilvie v. United States*, 117 S.Ct. 452 (1996); *Schleier*; *Burke*. However, in this case, the United States instead convinced the Tenth Circuit to broadly construe 26 C.F.R. §1.61-3(a) to exclude lifting costs from Petitioner's gross income. The United States did so only because a broad construction of the exclusion happened to result in higher taxes for Petitioner in this case, due to the unusual nature of personal holding company taxes. The United States is bound by this Court's holdings on the required specificity and narrow scope of exclusions from gross income, even in the unusual case such as this

one in which the application of the rule results in lower taxes. The Tenth Circuit's opinion is in irreconcilable conflict with this Court's decisions in *Glenshaw Glass*, *Jacobson*, *Schleier*, and *Burke*. Only certiorari relief from this Court will correct the wrong that has been committed.

The Tenth Circuit's opinion broadly construing the exclusion from gross income contained at 26 C.F.R. §1.61-3(a) to apply by analogy to the lifting costs of an oil and gas business violates a line of cases from this Court that began over forty years ago with *Jacobson* and *Glenshaw Glass* and has continued to the recent decisions in *Schleier* and *Burke*, all of which consistently and uniformly hold that the only exclusions from gross income are those which are specifically stated, and that those exclusions which are specifically stated must be narrowly construed.

The error committed by the Tenth Circuit is simple. In direct violation of the fundamental principles laid down by this Court governing the availability and construction of exclusions from gross income, the Tenth Circuit broadly construed 26 C.F.R. §1.61-3(a) to apply by analogy to exclude the lifting costs of an oil and gas

business from its gross income. The plain language of 26 C.F.R. §1.61-3(a) defines the gross income of a "manufacturing, merchandising, or mining business" as "total sales less the cost of goods sold[.]" The Tenth Circuit extended the regulation to apply to the lifting costs of an oil and gas business. In doing so, the Tenth Circuit narrowly construed the definition of gross income under 26 U.S.C. §61 and broadly construed the exclusion from gross income contained in 26 C.F.R. §1.61-3(a), in direct conflict with *Glenshaw Glass*, *Schleier*, and *Burke*. The result is a new exclusion from gross income which is not specifically stated in the Internal Revenue Code or Regulations, in violation of *Jacobson*.

The definition of gross income under the Internal Revenue Code is found at 26 U.S.C. §61(a)(2):

> "(a) GENERAL DEFINITION.-- Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including, but not limited to, the following items:
>
> . . .
>
> (2) Gross income derived from business[.]"

Although renumbered, this statute has been essentially unchanged since well before the *Jacobson* and *Glenshaw Glass* cases.

In *Glenshaw Glass*, this Court held that the definition of gross income under the Internal Revenue Code has a "sweeping scope" intended to bring the taxing power to bear on all constitutionally taxable receipts. 75 S.Ct. at 475, 477-8. Since that time, this Court has "repeatedly emphasized" the sweeping scope of the definition of gross income under the Internal Revenue Code. *Schleier*, 115 S.Ct. at 2163; *Burke*, 112 S.Ct. at 1870.

This Court has "also emphasized the corollary to §61(a)'s broad construction, namely the 'default rule of statutory construction that exclusions from income must be narrowly construed.'" *Schleier*, 115 S.Ct. at 2163, quoting *Burke*, 112 S.Ct. at 1878 (SOUTER, J., concurring).

The rule is also emphasized in the 26 C.F.R. §1.61-1(a), issued by the Internal Revenue Service under 26 U.S.C. §61(a), which provides that:

> "Gross income means all income from whatever source derived, unless excluded by law."

The rule that an item is included in gross income unless there is a specifically stated exclusion that applies has also been upheld by this Court on more than one occasion:

> "The income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed in the light of the same policy."

Jacobson, 69 S.Ct. at 369 (1949); See also, *United States v. Centennial Savings Bank*, 111 S.Ct. 1512, 1518 (1991).

The statute, cases from this Court, and the regulations are all clear that an item is included in gross income unless there is a specific exclusion available. There is no exclusion anywhere in the Internal Revenue Code or in the regulations issued by the Internal Revenue Service that excludes the lifting costs of an oil and gas business from its gross income. Only by broadly construing 26 C.F.R. §1.61-3(a) did the Tenth Circuit reach a contrary result, in violation of the principles that this Court has "repeatedly emphasized" for more than forty years. *Schleier*, 115 S.Ct. at 2163.

In its opinion, the Tenth Circuit stated that the "general rule is that 'gross income' means 'the total sales less the costs of goods sold.'" The Tenth Circuit went on to state that 26 C.F.R. §1.61-3(a) applies this "general definition" to manufacturing, merchandising, or mining businesses. A-2. However: there simply is no such general rule. To the contrary, the general rule, as repeatedly emphasized by this Court is that an item is included in gross income unless a specific exclusion applies, and that any such exclusions from gross income must be narrowly construed. *Jacobson*; *Centennial Savings Bank*.

The error of the Tenth Circuit results from its reliance on *Laguna Royalty Co. v. Commissioner*, 27 T.C.M. (CCH) 164 (1968), *aff'd* 406 F.2d 703 (5th Cir. 1969), which in turn relied on Rev. Rul. 60-344, 1960-2 C.B. 186. The error in *Laguna Royalty* and Rev. Rul. 60-344 springs from the use of the undefined term "cost of operations" as an exclusion to determine the gross income of any business, in place of the clearly defined term "cost of goods sold" which is excluded to determine the gross income of a manufacturing, merchandising, or mining business under 26 C.F.R. §1.61-3(a). This was apparently done to fill a perceived void in the determination of the gross income from businesses other than manufacturing, merchandising, or mining for something akin to cost of goods sold. Such an analysis, however, is directly contrary to the holdings announced

repeatedly by this Court -- that the only exclusions from gross income are those that are specifically stated, and that even those must be narrowly construed. *Jacobson*; *Schleier*. Conspicuously, the Tenth Circuit did not mention *Schleier* or *Burke* in its opinion, nor did either the Fifth Circuit or the Tax Court in *Laguna Royalty* mention *Glenshaw Glass* or *Jacobson*.

The error of the use of "cost of operations" as a substitute for "cost of goods sold" to determine the gross income of a business is also clear in light of the fact that under 26 U.S.C. §162(a) "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are deducted from gross income to determine taxable income. The broad and ambiguous term "cost of operations" easily fits within the "ordinary and necessary" expenses of carrying on a business. Therefore, under the theory of the Tenth Circuit below and of *Laguna Royalty*, almost any item classified as an "ordinary and necessary" business expense could just as easily be reclassified as a "cost of operation" and excluded from gross income in the first instance, instead of being deducted from gross income to determine taxable income. This distinction is significant. There are numerous restrictions on the deductibility of expenses under 26 U.S.C. §162(a). If instead cost of operations can (or must) be excluded in determining gross income, any restrictions on deductions would be meaningless, because the taxpayer would simply exclude

the disputed items from gross income as "costs of operations." See, *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670, 673-4 (9th Cir. 1980)(limitation on deductibility of certain illegal payments as business expense did not apply where the payments were part of cost of goods sold and as such were excluded from gross income). Indeed, to use the language chosen by the Tenth Circuit, many if not most ordinary and necessary business expenses are also "analogous to costs of goods sold" and thus could be "properly excluded in arriving at gross income." The failure to follow *Schleier*, *Burke*, *Jacobson*, and *Glenshaw Glass* would thus allow a taxpayer to avoid many if not most of the restrictions on the deduction of business expenses contained in the Internal Revenue Code.

To arrive at its decision below, the Tenth Circuit had to broadly construe 26 C.F.R. §1.61-3(a) and analogize lifting costs to costs of goods sold, because there is no question that under the Internal Revenue Code the word "mining" does not include oil and gas production, and the term "costs of goods sold" does not include lifting costs.

The oil and gas business is not within the definition of mining under the Internal Revenue Code. Although Respondent argued below that there is no reason for distinguishing between mining and oil and gas

production for purposes of determining gross income, Respondent has offered no legal authority whatsoever that oil and gas production is within the definition of mining for purposes of the Internal Revenue Code, as noted by the District Court, A-22.

The Internal Revenue Code and the Internal Revenue Regulations consistently distinguish mining from oil and gas production. The word mining is not used interchangeably for oil and gas production anywhere in the Internal Revenue Code or the Internal Revenue Regulations. Instead, numerous provisions of both the Code and the Regulations use mining and oil and gas production in ways that leave no doubt that the two terms are not interchangeable.

The personal holding company tax provisions which are the subject of this case explicitly distinguish between mining and oil and gas production. 26 U.S.C. §543 consistently uses the phrase "mineral, oil, and gas royalties" throughout. 26 U.S.C. §543(b)(2)(B) distinguishes oil and gas exploration from mining. The adjustments in subparts (i) through (iv) of that section are made to royalty income both from minerals and from oil and gas, but are only made to working interest income from "an oil and gas well."

Mining is also distinguished from oil and gas production in the depletion provisions of the Internal

Revenue Code. 26 U.S.C. § 613(a) states that depletion is allowed in the case of "mines, wells, and other natural deposits" as listed in 26 U.S.C. § 613(b), which again refers to "mines, wells, and other natural deposits." 26 U.S.C. § 613(c)(1) defines "gross income from the property" for property other than an oil or gas well as the "gross income from mining." 26 U.S.C. § 613(c)(2) and (3) define "mining," and do not include references to extraction of oil and gas. 26 U.S.C. §613(c)(4)(H) lists certain oil shale, but not oil well, treatment processes as within the definition of mining. 26 U.S.C. §613(d) specifies that depletion of oil and gas wells must comply with 26 U.S.C. §613A in order to be allowed, while depletion from mining does not.

The regulations concerning depletion also explicitly distinguish between oil and gas production and mining. 26 C.F.R. §1-613-4(a) states that gross income from the property for all minerals except oil and gas means "gross income from mining." 26 C.F.R. §1.613-3 separately defines "gross income from the property" for oil and gas wells. 26 C.F.R. §1.613-4(f) defines "mining," and the definition clearly does not include oil and gas production from wells. 26 C.F.R. §1-614-3(e) defines "mine" as:

> "any excavation or other workings or series of related excavations or related workings, as the case may be, for the purpose of

> extracting any known mineral deposit except oil and gas deposits. For the purpose of the proceeding sentence, the term "excavations" or "workings" includes quarries, pits, shafts, and wells (except oil and gas wells)."

The Tenth Circuit's finding that lifting costs are analogous to costs of goods sold is totally unsupported by the record or by the law. Petitioner presented unrebutted evidence in the form of expert testimony to the District Court that lifting costs for an oil and gas business are not the same as or comparable to costs of goods sold. A-69.

A taxpayer's cost of goods sold is calculated by subtracting the cost of inventory on hand at the end of the year from the sum of the cost of inventory on hand at the beginning of the year plus the cost incurred during the year in acquiring new inventory. *All-Steel Equipment, Inc. v. Commissioner*, 54 T.C. 1749, 1751 (1970), *aff'd in part and rev'd in part on the grounds*, 467 F.2d 1184 (7th Cir. 1972).

26 U.S.C. §471, and the regulations issued under it, deal with calculating cost of goods sold through the calculation of inventories. There is a specific regulation setting forth the calculation of inventories of miners and manufacturers, 26 C.F.R. §1.471-7, and another regulation setting forth the calculation of inventories of

retail merchants, 26 C.F.R. §1.471-8. There is no regulation setting forth the calculation of inventories for oil and gas businesses.

The one constant factor in the calculation of cost of goods sold is the "cost" must be tied to some specific "goods sold." The last sentence of 26 C.F.R. §1.61-3(a) specifically recognizes this, because it requires that an amount cannot be included as part of cost of goods sold before the tax year in which economic performance occurs with respect to the amount -- the tax year in which the goods are sold. Thus, calculation of cost of goods sold requires that an inventory be kept. However, oil and gas exploration and production companies as such Petitioner do not keep an inventory of the oil and gas they sell in a year. Without inventory, it is impossible to calculate cost of goods sold. A-69.

In order to apply 26 C.F.R. §1.61-3(a) to Petitioner, the Tenth Circuit thus had to go outside of the plain language of the regulation. It did so by analogizing "lifting costs" to "costs of goods sold." However, in doing so the Tenth Circuit violated *Jacobson*, *Glenshaw Glass*, *Schleier*, and *Burke*.

RELIEF REQUESTED AND CONCLUSION

Petitioner asks this Court to grant certiorari to correct the Tenth Circuit's error in violating this Court's

cases holding that exclusions from gross income are only available if specifically stated that such exclusions must be narrowly construed, by reversing the decision of the Tenth Circuit and reinstating the Judgment entered by the District Court.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 96-5101
(D.C. No. 93-C-0036-B)
(N.D. Okla.)

[File Stamped 6/19/97]

RHOADES OIL COMPANY,
Plaintiff-Appellee

vs.

UNITED STATES OF AMERICA,
Defendant-Appellant.

ORDER AND JUDGMENT*

Before BALDOCK, BRORBY, and MURPHY, Circuit Judges.

Plaintiff-Appellee Rhoades Oil Company (taxpayer) is engaged in the exploration for and production of oil and gas. On audit, the Internal Revenue Service (IRS) determined that taxpayer was subject to personal holding company tax under 26 U.S.C. § 541 for the years 1988, 1989, and 1990, in the amounts of $101,053, $163,188, and $144,392 respectively.

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*This order and judgment is not binding precedent, except under the doctrines of law of the case, res judicata, and collateral estoppel. The court generally disfavors the citation of orders and judgments; nevertheless, an order and judgment may be cited under the terms and conditions of 10th Cir. R. 36.3.

Taxpayer paid the additional tax and filed a claim for refund. The IRS failed to act on the refund and taxpayer brought suit in federal district court and prevailed. The government appeals from summary judgment granted in favor of taxpayer. Our jurisdiction arises under 28 U.S.C. § 1291 and we reverse.

The facts are stipulated and undisputed. The narrow issue of law before us is whether lifting or production costs incurred by an oil producer are properly excluded from gross income in calculating "adjusted ordinary gross income" for personal holding company tax purposes. See 26 U.S.C. § 542(a)(1); 543(b)(2)(B). If so, more than 60% of the taxpayer's adjusted ordinary gross income is "personal holding company income," 26 U.S.C. § 543(a), and the tax is properly imposed in this case. The taxpayer concedes that the other requirement for imposition of the tax, namely the stock ownership requirement of 26 U.S.C. § 542(a)(2) is met.

We have carefully reviewed the submissions of the parties, and we are persuaded that lifting costs are analogous to costs of goods sold and properly excluded in arriving at gross income, and hence adjusted ordinary gross income, for purposes of the personal holding company tax. See Laguna Royalty Co. v. Commissioner, 27 T.C.M. (CCH) 164 (1968), aff'd 406 F.2d 703 (5th Cir. 1969); Rev. Rul. 60-344, 1960-2 C.B. 186. "Gross income" includes "[g]ross income derived from business," 26 U.S.C. § 61(a)(2), and the general rule is that "'gross income means "the total sales less the costs of goods sold." 26 C.F.R. § 1.61-3(a)(applying general definition to manufacturing, merchandising or mining business). See also § 1.542-2 (cross referencing 26 U.S.C. § 61 and 26 C.F.R. § 1.61.1 to 1.61-14 in defining gross

income for personal holding company tax purposes and stating "[u]nder such provisions gross income is not necessarily synonymous with gross receipts"). The fact that "gross income from the property" may be defined in a different fashion elsewhere in the Code or Treasury Regulations for purposes of depletion, see 26 C.F.R. § 1.613-3 (definition for purposes of 26 U.S.C. § 613(c)), does not address the issue before us. See Laguna Royalty Co., 27 T.C.M. (CCH) at __, 1968 WL 1158 at *3-4. We conclude that the IRS's position is supported by the regulations relied upon and is reasonable; hence, we may not disregard it. National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 484 (1979).

REVERSED.

Entered for the Court,

Bobby R. Baldock
Circuit Judge

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA
Case No. 93-C-0036-H

[File Stamped 2/15/96]

RHOADES OIL COMPANY,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

ORDER

This matter comes before the Court on a Motion for Summary Judgment by Plaintiff Rhoades Oil Company, Inc. ("Rhoades Oil") and a Cross-Motion for Summary Judgment by Defendant United States. For the reasons expressed herein, the Court grants Plaintiff's Motion for Summary Judgment and denies Defendant's Cross-Motion.

Plaintiff commenced this civil tax action suit pursuant to 26 U.S.C. § 7422 to recover alleged overpayments made to the United States in connection with personal holding company taxes and interest thereon assessed against Plaintiff for taxable years 1988, 1989, and 1990, in the total amount of $503,689.00. The assessment stemmed from the determination by the Internal Revenue Service (the "Service") that Plaintiff is a "personal holding company" within the meaning of the Internal Revenue Code (the "Code") §§ 541-

543, and therefore subject to the personal holding company tax.

I

The basic facts of this case are set forth in the Stipulation of Facts filed with the Court on November 9, 1993 and supplemented on May 31, 1994.

Rhoades Oil was founded in 1945 by Sam J. Rhoades, Sr. for the purpose of exploring and producing oil and gas. Since its inception, Rhoades Oil has been an oil and gas company, and its only activities have been the exploration and production of oil and gas reserves. These activities include purchasing oil and gas leases, drilling wells, and acting as the operator for producing wells.

Rhoades Oil is a closely-held Delaware corporation with its principal place of business in Tulsa, Oklahoma. The stock of the company is owned as follows:

	Pre-9/89		Post-9/89	
Common Stock (No Par)				
Sam J. Rhoades	50%	305.0	66.7%	305.0
Nona M. Rhoades	25%	147.5	33.3%	146.5
Sam J. Rhoades, Jr.	25%	147.5	0.0%	0.0
Total Shares (Common) Outstanding		600.0		452.5
Preferred Stock (Par $ 100)				
Sam J. Rhoades, Trust	50%	100.0	66.7%	100.0
Nona M. Rhoades, Trust	25%	50.0	33.3%	50.0
Sam J. Rhoades, Trust	25%	50.0	0.0%	0.0

Total Shares (Preferred)		
Outstanding	200.0	150.00

Rhoades Oil redeemed the shares of Sam J. Rhoades following his death in 1989. During the last half of each of the taxable years at issue more than 50 percent of the outstanding stock of Rhoades Oil was owned by no more than 5 individuals.

The income of Rhoades Oil from its oil and gas business is derived from working interests, overrides, and royalty interests. A working interest is ownership of an oil and gas lease. The owner receives the gross receipts from the sale of oil and gas, less royalty payments and severance taxes, and bears the drilling and operating expenses of the well. The overrides of Rhoades Oil were created when the company owned a working interest in certain wells, but converted the working interest into an override. The overrides do not bear any expenses of drilling or operations. A royalty interest also bears no drilling or operating expenses. In 1988 through 1990, Rhoades Oil received the following revenues from working interests, overrides, and royalty interests:

	1988	1989	1990
Working Interests	$1,162,000	$1,211,000	$1,316,000
Overrides and Royalties	$ 56,000	$ 46,000	$ 56,000

As of January 1, 1988, January 1, 1989, and January 1, 1990, Rhoades Oil had retained earnings of $17,710,020, $18,977,833, and $14,273,523, respectively. The investment income of Rhoades Oil is derived from the investment of the company's retained earnings, mostly in Treasury Bills and publicly-traded stocks.

The original Forms 1120 - U.S. Corporation Income Tax Returns filed by Rhoades Oil for taxable years 1988, 1989, and 1990 did not reflect a liability for any personal holding company tax.

On or about July 31, 1991, Rhoades Oil received a letter from the Service notifying Rhoades Oil of proposed federal income tax deficiencies under Section 541 et seq. of the Code, the personal holding company tax provisions. This Notice of Deficiency proposed deficiencies as follows:

Taxable Year	Additional Tax
1988	$101,053.00
1989	$163,188.00
1990	$144,392.00

On April 16, 1992, Plaintiff executed IRS Form 870, Waiver of Restrictions on Assessment and Collection of Tax and Acceptance of Overassessment, and on May 24, 1992, made advance payments of the deficiencies in the following amounts:

Year	Tax	Interest
1988	$101,053.00	$ 39,895.85
1989	$163,188.00	$ 39,701.06
1990	$144,392.00	$ 15,459.48
	Total	$503,689.39

These deficiencies were subsequently assessed on July 6, 1992.

On or about May 22, 1992, Rhoades Oil filed three separate Forms 1120X - Amended U.S. Corporation Income Tax Returns for taxable years 1988, 1989, and 1990, which

served as its claims for refund.** In these Amended Returns, Rhoades Oil sought a refund of all personal holding company tax paid for taxable years 1988, 1989, and 1990, plus interest. The Service neither approved nor denied these claims within the six-month period following the filing of these claims.

In calculating its personal holding company income for taxable years 1988, 1989, and 1990, Rhoades Oil did not deduct "lifting costs"*** from gross income when determining its adjusted ordinary gross income from working interests under Section 542(a)(1). Using this method, Rhoades Oil's personal holding company income did not exceed 60 percent of its adjusted ordinary gross income and, accordingly, it was not treated as a personal holding company under Section 542.

On its tax returns, Rhoades Oil treated Lease Operating Expenses (lifting costs) as part of its "Cost of Goods Sold." For non-tax accounting purposes, Rhoades Oil treated Lease Operating Expenses as part of its "Cost of Operations" which is subtracted from Gross Receipts in arriving at Gross Profits.

On audit, the Service followed Revenue Ruling 60-

**Pursuant to the Joint Stipulation of Facts, the United States does not admit any facts set forth in the 1988, 1989, and 1990 Forms 1120X, except as expressly stated.

***The term "lifting costs" when used in the oil and gas industry is usually considered to be synonymous with "operating costs," and consists of those deductible costs incurred in the production of oil and gas after the completion of drilling and before its removal from the property for sale or transportation, e.g. labor, superintendence, supplies, repairs, and assets having a life not in excess of one year, maintenance, and applicable overhead costs. See Rev. Rul. 60-344, 1960-2 C.B. 186.

344, 1960-2 C.B. 186, and deducted lifting costs from gross sales of oil and gas to calculate "gross income" for purposes of the personal holding company test. Using this calculation of "gross income," the Service determined that Rhoades Oil was a personal holding company under Section 542 and was therefore subject to the tax on undistributed personal holding company income under Section 541.

II

Summary judgment is appropriate where "there is no genuine issue as to any material fact," Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986); Windon Third Oil & Gas Drilling Partnership v. Federal Deposit Insurance Corp., 805 F.2d 342, 345 (10th Cir. 1986), cert. denied, 480 U.S. 947 (1987), and "the moving party is entitled to judgment as a matter of law," Fed. R. Civ. P. 56(c). In Celotex, the Supreme Court stated:

> [t]he plain language of Rule 56 (c) mandates the entry of summary judgment, after adequate time for discovery and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial.

477 U.S. at 322.

A party opposing a properly supported motion for summary judgment must offer evidence, in admissible form, of specific facts, Fed. R. Civ. P. 56(e), sufficient to raise a "genuine issue of material fact." Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986) ("[T]he mere existence of some alleged factual dispute between the parties will not

defeat an otherwise properly supported motion for summary judgment."). "Factual disputes that are irrelevant or unnecessary will not be counted." Id. at 248.

Summary judgment is only appropriate if "there is [not] sufficient evidence favoring the nonmoving party for a jury to return a verdict for that party." Id. at 250. The Supreme Court stated:

> [t]he mere existence of a scintilla of evidence in support of the plaintiffs position will be insufficient; there must be evidence on which the jury could reasonably find for the plaintiff.

Id. at 252. Thus, to defeat a summary judgment motion, the nonmovant "must do more than simply show that there is some metaphysical doubt as to the material facts." Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 585-86 (1986); Anderson, 477 U.S. at 250 ("[T]here is no issue for trial unless there is sufficient evidence favoring the nonmoving party for a jury to return a verdict for that party. If the evidence is merely colorable, or is not significantly probative, summary judgment may be granted." (citations omitted)).

In essence, the inquiry for the Court is "whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law." Anderson, 477 U.S. at 250. In its review, the Court construes the record in the light most favorable to the party opposing summary judgment. Boren v. Southwestern Bell Tel. Co., 933 F.2d 891, 892 (10th Cir. 1991).

III

The language of the statute and the legislative history

of the personal holding company tax provisions make clear that any corporation that falls within the technical provisions of the statute will be deemed a "personal holding company." H.R. Rep. No. 704, 73d Cong., 2d Sess. 11-12 (1934).**** "The provision is designed so that there is no necessity to prove a purpose to avoid surtaxes [on wealthy individuals], and it has been considerably strengthened and improved by the Revenue Act of 1937." H.R. Rep. No. 1860, 75th Cong., 3d Sess. 3 (1938). See American Package Corp. v. Commissioner, 125 F.2d 413, 416-17 (4th Cir. 1942) (noting that, unlike the accumulated earnings tax, the personal holding company tax must be applied regardless of whether there is a legitimate business purpose); Investors Ins. Agency v. Commissioner, 72 T.C. 1027, 1032-33 (1979), aff'd, 677 F.2d 1328 (9th Cir. 1982) (applying personal holding company tax despite being a trap for the unwary); Montgomery Coca-Cola Bottling Co. v United States, 615 F.2d 1318, 1323 (Cl. Ct. 1980) (tax is "automatic upon qualification under the objective criteria of sections 541 et seq., and . . . does not turn on a tax avoidance motive").

A "personal holding company" is defined in Section 542(a) of the Code as follows:

**** As Defendant stated in its brief, the goal of Congress in enacting the personal holding company tax was to prevent the use of "incorporated pocketbooks" by high-bracket individual taxpayers to shield their investment income from tax at the steeply graduated individual tax rates while retaining control over the underlying portfolio securities through their control of the personal holding company. To accomplish this goal, Congress established a set of mechanical tests for determining whether a company was a personal holding company. Def.'s Resp. Br. at 8.

(a) GENERAL RULE.- For purposes of this subtitle, the term "personal holding company" means any corporation * * * if--

(1) ADJUSTED ORDINARY GROSS INCOME REQUIREMENTS. At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a), and

(2) STOCK OWNERSHIP REQUIREMENT. At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

The parties have stipulated that during the last half of each taxable year at issue, more than 50 percent of the outstanding stock of Rhoades Oil was owned by no more than 5 individuals. Plaintiff therefore has satisfied the stock ownership test set forth in Section 542(a)(2).

If a corporation meets the stock ownership test of Section 542(a)(2), under the terms of Section 542(a)(1) it will be subject to the 28 percent tax on its undistributed personal holding company income if its personal holding company income comprises 60 percent or more of its "adjusted ordinary gross income," as that term is defined in Section 543(b). Because the amount of Rhoades Oil's personal holding company income is not in dispute, the sole issue is the proper method for determining its "adjusted ordinary gross income".

The term "ordinary gross income" is defined in

Section 543(b)(1) as:

(b) DEFINITIONS - For purposes of this part -

(1) ORDINARY GROSS INCOME. - The term "ordinary gross income" means the gross income determined by excluding -

(A) all gains from the sale or other disposition of capital assets,

(B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b), and

(C) in the case of a foreign corporation...

The term "adjusted ordinary gross income" is defined in Section 543(b)(2) as:

(2) ADJUSTED ORDINARY GROSS INCOME. The term "adjusted ordinary gross income" means the ordinary gross income adjusted as follows:

* * *

(B) MINERAL ROYALTIES, ETC - From the gross income from mineral, oil, and gas royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for -

(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from royalties or such gross income from working interests in oil or

gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed gross income from such working interests.

As Defendant stated in its brief, the determination of "adjusted ordinary gross income" may be illustrated as follows:

	Gross Income
less:	Items described in Section 543(b)(1)(A)-(C)
equals:	Ordinary Gross Income

and

	Ordinary Gross Income
less:	Items described in Section 543(b)(2)(B)(I)-(iv)
equals:	Adjusted Ordinary Gross Income

The parties do not dispute the amounts of the adjustments to be made under Section 543(b)(1)(A)-(C) to reduce "gross income" to "ordinary gross income", or under Section 543(b)(2)(B)(i)-(iv) to arrive at "adjusted ordinary gross income." The parties disagree, however, as to the proper definition of "gross income" under Section 543(b)(1), the starting point of the calculation. The question for the Court, therefore, is what constitutes "gross income" for purposes of Section 543(b)(1) and the applicable regulations in effect and pertinent to the taxable years at issue.

IV

Defendant claims that under Section 543 and the applicable regulations "gross income" means gross sales (or

receipts or revenues) reduced by "lifting costs." In support of this view, Defendant relies almost exclusively on Revenue Ruling 60-344, 1960-2 C.B. 186 and Laguna Royalty Co. v. Commissioner, 406 F.2d 703 (5th Cir. 1969), aff'g, 27 T.C.M. (CCH) 164 (1968). Based on these authorities, and using this method of calculating "gross income," Defendant argues that Rhoades Oil should be classified as a personal holding company for the taxable years in question. The Court, however, believes that Defendant's reliance upon these authorities is misplaced.

In Revenue Ruling 60-344, the taxpayer sought advice as to whether "lifting costs" constitute a part of production costs in the determination of "gross income" from oil production under the provisions of Section 61 (a) of the Code relating to the definition of gross income, and Section 542(a) of the Code relating to the definition of a personal holding company.

At the time of Revenue Ruling 60-344, Section 61(a) provided that "gross income means all income from whatever source derived, including (but not limited to) . . . (2) Gross income derived from business...." These provisions remained in effect through taxable years 1988, 1989, and 1990. By contrast, however, Section 542 and Section 543, which were subsequently amended in 1964, were materially different prior to the taxable years at issue here, stating in applicable part:

> Section 542 [1954 Code]. (a) GENERAL RULE. - For purposes of this subtitle, the term "personal holding company" means any corporation . . . if-
>
> (1) GROSS INCOME

> REQUIREMENT. - At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543 . . .
>
> Section 543 [1954 Code]. (a) GENERAL RULE. - For purposes of this subtitle, the term "personal holding company income" means the portion of the gross income which consists of:
>
> (1) DIVIDENDS * * *
> (2) STOCK AND SECURITIES TRANSACTIONS * * *
> (3) COMMODITIES TRANSACTIONS * * *
> (4) ESTATES AND TRUSTS * * *
> (5) PERSONAL SERVICE CONTRACTS * * *
> (6) USE OF CORPORATION PROPERTY BY SHAREHOLDERS * * *
> (7) RENTS * * *
> (8) MINERAL, OIL AND GAS ROYALTIES * * *

Therefore, the question presented to the Service in Revenue Ruling 60-344 was the meaning of the term "gross income" as used in these pre-1964 provisions of the Code.

Moreover, without reasoning or justification, Revenue Ruling 60-344 declared that Treas. Reg. § 1.61 -3,***** which

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***** Treas. Reg. § 1.61-3(a) provides in applicable part:

(a) *In general.* In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in Section 1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are a type for which

by its terms pertains to "a manufacturing, merchandising, or mining business", applied equally to an oil and gas business for purposes of Section 542, and proceeded to analyze the treatment of "lifting costs" under this provision of the regulations.******

Revenue Ruling 60-344 concluded that:

> . . . in the case of oil and gas producing properties, "lifting costs" constitute a portion of the cost of producing oil and gas and must be subtracted from gross sales in computing gross income for the purpose of determining whether personal holding company income, as defined in section 543 of the Code, is at least 80 percent of the corporation's gross income for a taxable year.

In Laguna Royalty Co., the Fifth Circuit adopted

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a deduction would be disallowed under Section 162(c), (f), or (g) in the case of a business expense. The costs of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

******Revenue Ruling 60-344 expressly relied upon Treas. Reg. § 1.61 -3 stating:

> Section 61(a) of the Code provides, in part, that gross income includes gross income derived from business. Section 1.61 -3 of the regulations defines gross income in the case of manufacturing, merchandising, or mining business as total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining gross income, a subtraction should not be made for depletion allowances based on a percentage of income, selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. However, a taxpayer may elect to subtract for depreciation or depletion based on cost incurred in connection with the production of goods or materials in determining gross income. See Rev. Rul. 141, C.B. 1953-2, 101.

without discussion the findings and conclusions of the Tax Court memorandum opinion. 406 F.2d 703. In turn, the memorandum opinion, without informative analysis, adopted Revenue Ruling 60-344 and determined that the issue should be decided under I.R.C. § 61(a)(2) and Treas. Reg. § 1.61-3.******* The Tax Court concluded:

> We agree with respondent that, in the instant case, the term gross income" means the gross sales in the amount for which the oil and gas was sold in the immediate vicinity of the wells, less "lifting costs." This position, as set forth in Rev. Rul. 60344, 1960-2 C.B. 186 is that:
>
> > [i]n the case of oil and gas producing properties, "lifting costs" constitute a portion of the cost of producing the oil and gas and must be subtracted from gross sales in computing gross income for the purpose of determining whether personal holding company income, as defined in section 543 of the

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*******The Court observes that in Laguna Royalty Co., as here, the taxpayer argued that the treatment of "lifting costs" should be determined by applying the definition of "gross income" contained in Section 613 of the Code. 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968). The Tax Court properly rejected the taxpayer's argument and analyzed that case under Section 61, stating in part, "[t]he term 'gross income from the property', as used in Section 613 for the purposes of measuring the depletion or exhaustion of the natural resource, is not the same as 'gross income' as used in Section 542(a)(1) for the purpose of determining personal holding company tax liability." Id. Similarly, in the instant case, this Court finds that Section 61, and not Section 613, controls the definition of "gross income," and thus Rhoades Oil's argument to the contrary is without merit. Accord Treas. Reg. § 1.542-2. As discussed more fully below, the Court departs from Laguna Royalty Co. by concluding that Treas. Reg. § 1.61-3, which refers to "mining," does not also apply to "oil and gas" under the statute as it existed following the 1964 amendments.

> Internal Revenue Code of 1954, is at least 80 percent of the corporation's total gross income for a taxable year.

In our opinion this is a correct statement of the rule applicable herein.

With respect to Treas. Reg. § 1.61-3, the Tax Court stated:

> Section 61 provides, in pertinent part, that gross income includes "gross income derived from business," and section 1.61-3 of the Regulations defines gross income in the case of a manufacturing, merchandising or mining business as total sales, less cost of goods sold.

V

The authorities cited by Defendant all rely upon Treas. Reg. § 1.61-3 in deciding that "lifting costs" must be subtracted from gross receipts to determine "gross income" under Section 543(b)(1). These decisions apparently are based on the view that the oil and gas business is included in the phrase "manufacturing, merchandising, or mining business" contained in the regulation.

Whether these authorities, which construed the term "gross income" for purposes of Section 542(a)(1) of the pre-1964 statute, were correctly decided, need not be determined here. Indeed, nothing in the pre-1964 statute is presently before this Court. What is before the Court is the law in effect and applicable to taxable years 1988,1989, and 1990. The Court finds that Revenue Ruling 60-344 and the case law cited by Defendant in its brief all pertain to the pre-1964 statute and thus are not binding in deciding the instant case. Accordingly, the Court must look to the plain language of the Code and the regulations in effect during the taxable years at

issue.

Two of the relevant provisions of the Code provide as follows:

> SECTION 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX. In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 39.6 percent of the undistributed personal holding company income.
>
> SECTION 542. DEFINITION OF PERSONAL HOLDING COMPANY. (a) GENERAL RULE - For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if-
>
> > (1) ADJUSTED ORDINARY GROSS INCOME REQUIREMENT. - At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)) ....

Revenue Ruling 60-344 construed the term "gross income" as set forth in Section 542 as it existed prior to 1964. Clearly, however, following the 1964 amendments, Section 542 no longer contained the term "gross income." Rather, the section used the term "adjusted ordinary gross income" instead of "gross income" and expressly stated that the term is defined in Section 543(b)(2).

The language in Section 543(b) is illuminating for at least two reasons. First, this is a new definition section added by the 1964 amendments to set forth a determination

of "adjusted ordinary gross income" step-by-step from "gross income" to "ordinary gross income," I.R.C. § 543(b)(1), and from "ordinary gross income" to "adjusted ordinary gross income," I.R.C. § 543(b)(2). Second, the provision sets forth the proper treatment of oil and gas royalties and working interests in oil and gas wells, and expressly distinguishes such royalties and interests from mineral royalties, which are also specifically addressed. I.R.C. § 543(b)(2)(B).

The question for this Court is the meaning of "gross income" as that term is used in Section 543(a)(1), the starting point of the relevant calculation. Defendant first contends that the Court should defer to Revenue Ruling 60-344, citing Dunn v. United States, 468 F. Supp. 991, 993 (S.D.N.Y. 1979) (holding that revenue rulings have "the power of legal precedents unless unreasonable or inconsistent with the provisions of the Internal Revenue Code.") This revenue ruling, however, construed the term "gross income" contained in Section 542 prior to the 1964 amendments. As a result of these amendments, Section 542 no longer contains the term "gross income." Instead, "gross income" is used as the starting point of the new definition section in Section 543(b), which definition section sets forth certain adjustments and other calculations including specific subtractions to arrive at the "gross income" both "from mineral, oil and gas royalties" and "from working interests in an oil and gas well." These adjustments and calculations were not in the pre-1964 statute. In light of the material changes in the statute, the Court rejects Defendant's contention that Revenue Ruling 60-344 and case law adopting its rationale control the instant case.

Defendant next contends that, even if Revenue Ruling 60-344 and the cases that follow this ruling are no longer controlling, the reasoning of such authorities should be followed. Under this theory, for the reasons described above, the Court would be required to apply Treas. Reg. § 1.61-3.

As noted above, Treas. Reg. § 1.61-3 applies to "a manufacturing, merchandising or mining business." Defendant, however, has identified no authority whatsoever to support its claim that "oil and gas" is synonymous with "mining". Moreover, anyone familiar with the history of Oklahoma is fully aware of the distinct contributions that the oil industry and the mining industry have each made to the State and, to date, the Court is unaware of any instance in which anyone. has confused one industry with the other.

The assertion by Defendant that "oil and gas" constitutes "mining" is even more incredible in the context of the statute itself. As noted above, Section 543(b)(2) expressly distinguishes between "oil," "gas," and "minerals." Thus, the drafters of Section 543(b)(2) were clearly aware of the differences between minerals, oil, and gas. Therefore, the Court assumes that the drafters of Section 543(b)(1) were also aware of this distinction. The Court finds that, for purposes of defining "gross income" as the starting point of the calculation in Section 543(b)(1), the drafters did not intend the term "mining" to encompass "oil and gas".

Although ignoring the plain language of both the statute and Treas. Reg. § 1.61-3, Defendant asserts further that "mining" must include "oil and gas," because each endeavor involves "the extraction of natural resources from the earth." In its brief, Defendant states that:

[t]here is nothing to suggest that the activities of

> Rhoades Oil should be treated differently than any mining activity for purposes of Treas. Reg. § 1.61-3(a) - both involve the extraction of natural resources from the earth. And for purposes of the personal holding company test, there can certainly be no rationale for distinguishing them.

As noted above, however, this statute is technical in nature and must be strictly applied according to its plain language. See Montgomery Coca-Cola Bottling Co., 615 F.2d at 1323. Strict statutory construction forbids substituting the term "oil and gas" for "mining" simply because they both involve the "extraction of natural resources from the earth." If the Commissioner and the Secretary of the Treasury had intended to apply Treas. Reg. § 1.61 -3 to "oil and gas" as well as to "mining", then this provision of the regulations should have referred to "the extraction of natural resources from the earth."******** See e.g. Granquist v. Hackleman, 264 F.2d 9, 16 (9th Cir. 1959) (stating "[a] Treasury Regulation has the force and effect of law only if it is consistent with and

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********Defendant argues that the fact that Congress "made no changes to the definition of 'gross income' in the Revenue Act of 1964 counsels that Congress acquiesced in the IRS's interpretation of Revenue Ruling 60-344. It is long-established that '[a]dministrative' construction must be deemed to have received legislative approval by the re-enactment of the statutory provision, without material change." This argument is wholly without merit. As noted herein, the 1964 amendments contained material changes to the statute, including a detailed definitional section that expressly distinguished between minerals and oil and gas. A more reasonable conclusion is that if the Service and the Department of Treasury had intended to continue to treat "oil and gas" in the same fashion as "mining," then the Commissioner and the Secretary would have amended the regulations to reflect the changes in the statute.

reasonably adapted to the enforcement of a revenue statute.")

In summary, the Court concludes that for purposes of determining "gross income" under Section 542, the controlling authority is Section 61. Section 1.61-3 of the regulations, however, does not apply to "oil and gas," because it only refers to "mining" and the statute specifically distinguishes between "minerals" and "oil and gas." I.R.C. § 543(b)(2)(B). The authorities cited by Defendant to the contrary are inapposite because this provision of the Code was materially amended in 1964, and the delineation between "minerals" and "oil and gas" was reflected in a new definitional section added by the 1964 amendments. Under general principles, "gross income" refers to "gross income derived from business." I.R.C. § 61(a)(2). Absent an express statement to the contrary in the statute or applicable regulations, "lifting costs" should be treated as operating costs under general principles and therefore should not be subtracted from gross profits to determine "gross income."

Applying these principles to the instant case, Rhoades Oil is not a personal holding company as that term is defined in Sections 541 through 543 of the Code for taxable years 1988, 1989, and 1990. Therefore, summary judgment is hereby granted for the Plaintiff.*********

*********Treas. Reg. § 1.61-3 provides that the "cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer." Accordingly, Plaintiff argues that the method of accounting consistently used by Rhodes Oil reflects "lifting costs" in the category "Operating Expenses" rather than in the category "Cost of Sales," and that this treatment should be respected under the regulations. Because the Court has determined that, for the reasons discussed herein, this regulation does not apply to "oil and gas," it is

IT IS SO ORDERED.
This 14th day of February, 1996.

/s/ Sven Erik Holmes
Sven Erik Holmes
United States District Judge

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unnecessary to reach this issue.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA
Case No. 93-C-0036-H

[File Stamped 2/20/96]

RHOADES OIL COMPANY,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

JUDGMENT

The Court duly considered the issues and rendered a decision in accordance with the order filed on February 15, 1996.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that judgment is hereby entered for the Plaintiff and against the Defendant for taxes and interest paid in the amount of $503,689.00, plus interest as allowed by law.

IT IS SO ORDERED.

This 19th day of February, 1996.

/s/ Sven Erik Holmes
Sven Erik Holmes
United States District Judge

STATUTES AND REGULATIONS

Title 26, United State Code

§ 61. Gross income defined.

(a) General definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(2) Gross income derived from business;

* * *

§ 162. Trade or business expenses.

(a) In general.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of

property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000. For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year.

* * *

§ 471. General rule for inventories.

(a) General rule.--Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

(b) Cross reference.-- For rules relating to capitalization of direct and indirect costs of property, see section 263A.

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§ 542. Definition of personal holding company.

(a) General rule.--For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if--

(1) Adjusted ordinary gross income requirement.--At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) Stock ownership requirement.--At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 401(a), 501(c)(17), or 509(a) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

* * *

§ 543 Personal holding company income.

(a) General rule.--For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:

(1) Dividends, etc.--Dividends, interest, royalties (other than mineral, oil, or gas royalties or

copyright royalties), and annuities.

. . .

(2) Rents.--The adjusted income from rents; except that such adjusted income shall not be included if--

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

(B) the sum of--

(i) the dividends paid during the taxable year (determined under section 562),

(ii) the dividends considered as paid on the last day of the taxable year under section 563(d) (as limited by the second sentence of section 563(b)), and

(iii) the consent dividends for the taxable year (determined under section 565), equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

(3) Mineral, oil, and gas royalties.--The

adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if--

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income,

(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than--

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162, equals or exceeds 15 percent of the adjusted ordinary gross income.

(4) Copyright royalties.--Copyright royalties; except that copyright royalties shall not be included if--

(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any

shareholder) constitute 50 percent or more of the ordinary gross income,

(B) the personal holding company income for the taxable year computed--

(i) without regard to copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder owning more than 10 percent of the total outstanding capital stock of the corporation,

(ii) without regard to dividends from any corporation in which the taxpayer owns at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C), and

(iii) by including as personal holding company income the adjusted income from rents and the adjusted income from mineral, oil, and gas royalties, is not more than 10 percent of the ordinary gross income, and

. . .

(6) Use of corporate property by shareholder.--

(A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use, tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).

(B) Subparagraph (A) shall apply only to a corporation which has personal holding company income in excess of 10 percent of its ordinary gross income.

(C) For purposes of the limitation in subparagraph (B), personal holding company income shall be computed--

(i) without regard to subparagraph (A) or paragraph (2),

(ii) by excluding amounts received as compensation for the use of (or right to use) intangible property (other than mineral, oil, or gas royalties or copyright royalties) if a substantial part of the tangible property used in connection with such intangible property is owned by the corporation and all such tangible and intangible property is used in the active conduct

of a trade or business by an individual a individuals described in subparagraph (A), and

(iii) by including copyright royalties and adjusted income from mineral, oil, and gas royalties.

. . .

(b) Definitions.--For purposes of this part--

(1) Ordinary gross income.--The term "ordinary gross income" means the gross income determined by excluding--

(A) all gains from the sale or other disposition of capital assets,

(B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b), and

. . .

(2) Adjusted ordinary gross income.--The term "adjusted ordinary gross income" means the ordinary gross income adjusted as follows:

. . .

(B) Mineral royalties, etc.--From the gross income from mineral, oil, and gas

royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for--

(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

(ii) property and severance taxes,

(iii) interest, and

(iv) rent, to the extent allocable, under regulations prescribed by the Secretary, to such gross income from royalties or such gross income from working interests in oil or gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interests.

. . .

(4) Adjusted income from mineral, oil, and gas royalties.--The term "adjusted income from mineral, oil, and gas royalties" means the gross income from mineral, oil, and gas royalties (including production payments and overriding royalties), reduced by the

amount subtracted under paragraph (2) (B) of this subsection in respect of such royalties.

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* * *

§613 Percentage depletion.

(a) General rule.--In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent (100 percent in the case of oil and gas properties) of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) Percentage depletion rates.--The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 22 percent--

(A) sulphur and uranium; and

(B) if from deposits in the United States--anorthosite, clay, laterite, and nephelite syenite (to the extent that alumina and aluminum compounds are extracted therefrom), asbestos, bauxite, celestite, chromite, corundum, fluorspar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, and zircon, and ores of the following metals: antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc.

(2) 15 percent--If from deposits in the United States--

(A) gold, silver, copper, and iron ore, and

(B) oil shale (except shale described in paragraph (5)).

(3) 14 percent--

(A) metal mines (if paragraph (1)(B) or (2)(A) does not apply), rock asphalt, and vermiculite; and

(B) if paragraph (1)(B), (5), or (6)(B) does not apply, ball clay, bentonite, china

clay, sagger clay, and clay used or sold for use for purposes dependent on its refractory properties.

(4) 10 percent--asbestos (if paragraph (1)(B) does not apply), brucite, coal, lignite, perlite, sodium chloride, and wollastonite.

(5) 7 1/2 percent--clay and shale used or sold for use in the manufacture of sewer pipe or brick, and clay, shale, and slate used or sold for use as sintered or burned lightweight aggregates.

(6) 5 percent--

(A) gravel, peat, pumice, sand, scoria, shale (except shale described in paragraph (2)(B) or (5)), and stone [FN1] except stone described in paragraph (7));

(B) clay used, or sold for use, in the manufacture of drainage and roofing tile, flower pots, and kindred products; and

(C) if from brine wells--bromine, calcium chloride, and magnesium chloride.

(7) 14 percent--all other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(B) does not apply) bauxite, flake graphite, fluorspar,

lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include--

(A) soil, sod, dirt, turf, water, or mosses;

(B) minerals from sea water, the air, or similar inexhaustible sources; or

(C) oil and gas wells.

For the purposes of this subsection, minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake within the United States shall not be considered minerals from an inexhaustible source.

(c) Definition of gross income from property.--For purposes of this section--

(1) Gross income from the property.--The term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

(2) Mining.--The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment

processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) Extraction of the ores or minerals from the ground.--The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(4) Treatment processes considered as mining.--The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

(A) In [FN2] the case of coal--cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(B) in the case of sulfur recovered by the Frasch process--cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(C) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product--sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment;

(D) in the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product--crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit;

(E) the pulverization of talc, the burning of magnesite, the sintering and nodulizing of phosphate rock, the decarbonation of trona, and the furnacing of quicksilver ores;

(F) in the case of calcium carbonates and other minerals when used in making

cement--all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(G) in the case of clay to which paragraph (5) or (6)(B) of subsection (b) applies--crushing, grinding, and separating the mineral from waste, but not including any subsequent process;

(H) in the case of oil shale--extraction from the ground, crushing, loading into the retort, and retorting, but not hydrogenation, refining, or any other process subsequent to retorting; and

(I) any other treatment process provided for by regulations prescribed by the Secretary which, with respect to the particular ore or mineral, is not inconsistent with the preceding provisions of this paragraph.

(5) Treatment processes not considered as mining.--Unless such processes are otherwise provided for in paragraph (4) (or are necessary or incidental to processes so provided for), the following treatment processes shall not be considered as "mining": electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping.

(d) Denial of percentage depletion in case of oil and gas wells.--Except as provided in section 613A, in the case

of any oil or gas well, the allowance for depletion shall be computed without reference to this section.

(e) Percentage depletion for geothermal deposits.--

(1) In general.--In the case of geothermal deposits located in the United States or in a possession of the United States, for purposes of subsection (a)--

(A) such deposits shall be treated as listed in subsection (b), and

(B) 15 percent shall be deemed to be the percentage specified in subsection (b).

(2) Geothermal deposit defined.--For purposes of paragraph (1), the term "geothermal deposit" means a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). Such a deposit shall in no case be treated as a gas well for purposes of this section or section 613A, and this section shall not apply to a geothermal deposit which is located outside the United States or its possessions.

(3) Percentage depletion not to include lease bonuses, etc.--In the case of any geothermal deposit, the term "gross income from the property" shall, for purposes of this section, not include any amount described in section 613A(d)(5).

[(4) Redesignated (3)]

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Title 26 Code of Federal Regulations

§1.61-1 Gross Income.

(a) General Definition. Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, §1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

* * *

§ 1.61-3 Gross income derived from business.

(a) In general. In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in § 1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a

deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446-1(c)(1)(ii)).

* * *

§ 1.471-7 Inventories of miners and manufacturers.

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product. See section 472 as to last-in, first-out inventories.

* * *

§ 1.471-8 Inventories of retail merchants.

(a) Retail merchants who employ what is known as the

"retail method" of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as--

(1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit. See §§ 1.263A-1 and 1.263A-3 for rules regarding the computation of costs with respect to property acquired for resale.

(b) For further adjustments to be made in the case of a retail merchant using the last-in, first-out inventory method authorized by section 472, see paragraph (k) of § 1.472-1.

(c) A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but

should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

(d) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

(f) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of § 1.446-1. A taxpayer filing a first return of income may adopt such practice subject to

approval by the district director upon examination of the return.

(g) A taxpayer using the last-in, first-out inventory method in conjunction with retail computations must adjust retail selling prices for mark-downs as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the taxable year regardless of market values.

* * *

§ 1.613-3 Gross income from the property.

In the case of oil and gas wells, gross income from the property, as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or filed price of the oil or gas before conversion or transportation.

* * *

§ 1.613-4 Gross income from the property in the case of minerals other than oil and gas.

(a) In general. The rules contained in this section are applicable to the determination of gross income from the property in the case of minerals other than oil and gas and the

rules contained in § 1.613-3 are not applicable to such determination, notwithstanding provisions to the contrary in § 1.613-3. The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before January 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after December 31, 1960) will be referred to as "mining processes." Processes, including packaging and transportation, which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation." See paragraph (f) of this section for the definition of the term "mining" and paragraph (g) of this section for rules relating to nonmining processes.

. . .

(f) Definition of mining--

(1) In general. The term "mining" includes only--

(i) The extraction of ores or minerals from the ground;

(ii) Mining processes, as described in subparagraphs (2) through (6) of this paragraph; and

(iii) So much of the transportation (whether or not by common carrier) of ores or minerals from the point of extraction of the ores or minerals from the ground to the plants or mills in which the processes referred to in subdivision (ii) of this subparagraph are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over such greater distance as the Commissioner authorizes. See paragraph (h) of this section for rules relating to the filing of applications to treat as mining any transportation in excess of 50 miles.

(2) Definition of mining processes.

(i) As used in subparagraph (1)(ii) of this paragraph, the term "mining processes" means, for taxable years beginning before January 1, 1961, the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, including the following processes (and the processes necessary or incidental thereto), and, for taxable years beginning after December 31, 1960, the following processes (and the

processes necessary or incidental thereto):

(a) In the case of coal--cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(b) In the case of sulfur recovered by the Frasch process--cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(c) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product (as defined in subparagraph (3)(iv) of this paragraph)--

(1) Where applied for the purpose of bringing to shipping grade and form (as defined in subparagraph (3)(iii) of this paragraph)--sorting, concentrating, sintering, and substantially equivalent processes, and

(2) Loading for shipment.

(d) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily

sold in the form of the crude mineral product--crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit; and

(e) In the case of the following ores or minerals--

(1) The furnacing of quicksilver ores,

(2) The pulverization of talc,

(3) The burning of magnesite, and

(4) The sintering and nodulizing of phosphate rock.

(ii) The term "mining processes" also includes the following processes (and, except as otherwise provided in this subdivision, the processes necessary or incidental thereto):

(a) For taxable years beginning

after December 31, 1960, in the case of calcium carbonates and other minerals when used in making cement--all processes (other than preheating the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(b) For taxable years beginning after December 31, 1960, and before November 14, 1966, in the case of clay to which former section 613(b)(5)(B) applied, and for taxable years beginning after November 13, 1966, in the case of clay to which section 613(b)(5) or (6)(B) applies--crushing, grinding, and separating the clay from waste, but not including any subsequent process;

(c) For taxable years beginning after October 9, 1969, in the case of minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake (as defined in paragraph (b) of § 1.613-2)--the extraction of such minerals from the brines, but in no case including any further processing or refining of such extracted minerals; and

(d) For taxable years beginning after December 30, 1969, in the case

of oil shale (as defined in paragraph (b) of § 1.613-2)--extraction from the ground, crushing, loading into the retort, and retorting, but in no case hydrogenation, refining, or any other process subsequent to retorting.

(iii) A process is "necessary" to another related process if it is prerequisite to the performance of the other process. For example, if the concentrating of low-grade iron ores to bring to shipping grade and form cannot be effectively accomplished without fine pulverization, such pulverization shall be treated as a process which is "necessary" to the concentration process. Accordingly, because concentration is a mining process, such pulverization is also a mining process. Furthermore, if mining processes cannot be effectively applied to a mineral without storage of the mineral while awaiting the application of such processes, such storage shall be treated as a process which is "necessary" to the accomplishment of such mining processes. A process is "incidental" to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal, prior to loading for shipment, with dots of paper to identify the coal for trade-name purposes will

be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process. Also, where crushing of a crude mineral is treated as a mining process, the production of fines as a byproduct is ordinarily the coincidental result of the application of a mining process. If a taxpayer demonstrates that, as a factual matter, a particular process is necessary or incidental to a process named as a mining process in section 613(c)(4) of this paragraph, the necessary or incidental process will also be considered a mining process.

(iv) The term "mining" does not include purchasing minerals from another. Accordingly, the processes listed in this paragraph shall be considered as mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect of which he is entitled to a deduction for depletion under section 611. The application of these processes to purchased ores, minerals, or materials does not constitute mining.

(3) Processes recognized as mining for ores or minerals covered by section 613(c)(4)(C).

(i) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the terms "sorting" and "concentrating" mean the process of eliminating substantial amounts of the impurities or foreign matter associated

with the ores or minerals in their natural state, or of separating two or more valuable minerals or ores, without changing the physical or chemical identity of the ores or minerals. Examples of sorting and concentrating processes are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink-and-float processes, classifiers, hydrotators and flotation processes. Under section 613(c)(4)(C), sorting and concentration will be considered mining processes only where they are applied to bring an ore or mineral to shipping grade and form.

(ii) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the term "sintering" means the agglomeration of fine particles by heating to a temperature at which incipient, but not complete, fusion occurs. Sintering will be considered a mining process only where it is applied to an ore or mineral, or a concentrate of an ore or mineral, as an auxiliary process necessary to bring the ore or mineral to shipping form. A thermal action which is applied in the manufacture of a finished product will not be considered to be a mining process even though such thermal action may cause the agglomeration of fine particles by incipient fusion, and even though such action does not cause a chemical change

in the agglomerated particles. For example, the sintering of finely ground iron ore concentrate, prior to shipment from the concentration plant, for the purpose of preventing the risk of loss of the finely divided particles during shipment is considered a mining process. On the other hand, for example, a heating process applied to expand or harden clay, shale, perlite, vermiculite, or other materials in the course of the manufacture of lightweight aggregate or other building materials is not considered to be a mining process.

(iii) As used in section 613(c)(4)(C) and this section, to "bring to shipping grade and form" means, with respect to taxable years beginning after December 31, 1960, to bring (by the application of mining processes at the mine or concentration plant) the quality or size of an ore or mineral to the stage or stages at which the ore or mineral is shipped to customers or used in nonmining processes (as defined in paragraph (g) of this section) by the taxpayer.

(iv) An ore or mineral is "customarily sold in the form of a crude mineral product", within the meaning of section 613(c)(4)(C), if a significant portion of the production thereof is sold or used in a nonmining process prior to the alteration of its inherent mineral content by some form of beneficiation, concentration, or

ore dressing. An ore or mineral does not lose its classification as a crude mineral product by reason of the fact that, before sale or use in a nonmining process, the ore or mineral may be crushed or subjected to other processes which do not alter its inherent mineral content. Whether the portion of production sold or used in the form of a crude mineral product is a significant portion of the total production of an ore or mineral is a question of fact.

(4) Type of processes recognized as mining for ores or minerals covered by section 613(c)(4)(D). Cyanidation, leaching, crystallization, and precipitation, which are listed in section 613(c)(4)(D) as treatment processes considered as mining, and the processes (or combination of processes) which are substantially equivalent thereto, will be recognized as mining only to the extent that they are applied to the taxpayer's ore or mineral for the purpose of separation or extraction of the valuable mineral product or products from the ore, or for the purpose of separation or extraction of the mineral or minerals from other material extracted from the mine or other natural deposit. A process, no matter how denominated, will not be recognized as mining if the process beneficiates the ore or mineral to the degree that such process, in effect, constitutes smelting, refining, or any other nonmining process within the meaning of paragraph (g) of this section. As used in section 613(c)(4)(D) and subparagraph (2)(i)(d) of this paragraph, the term "concentration" has the meaning

set forth in the first two sentences of subparagraph (3)(i) of this paragraph.

(5) Processes recognized as mining under section 613(c)(4)(I). Under the authority granted the Secretary or his delegate in section 613(c)(4)(I), the processes which are described in subdivisions (i) through (iv) of this subparagraph, and the processes necessary or incidental thereto, are recognized as mining processes for taxable years beginning after December 31, 1960. The processes described in subdivisions (i) through (iv) of this subparagraph are in addition to the specific processes recognized as mining under section 613(c)(4). Such additional processes are:

(i) Crushing and grinding, but not fine pulverization (as defined in paragraph (g)(6)(v) of this section);

(ii) Size classification processes applied to the products of an allowable mining process;

(iii) Drying to remove free water, provided that such drying does not change the physical or chemical identity or composition of the mineral; and

(iv) Washing or cleaning the surface of mineral particles (including the washing of sand and gravel and the treatment of kaolin particles to remove surface stains), provided that such washing or cleaning does not activate or otherwise change the physical or chemical

structure of the mineral particles.

(6) In the case of a process applied subsequent to a nonmining process, see paragraph (g)(2) of this section.

* * *

§1.614-3 Rules relating to separate operating mineral interests in the case of mines.

(e) Mine Defined. For purposes of this section, the term "mine" means any excavation or other workings or series or related excavations or related workings, as the case may be, for the purpose of extracting any known mineral deposit, except oil and gas deposits. For the purpose of the proceeding sentence, the term "excavations" or "workings" includes quarries, pits, shafts, and wells (except oil and gas wells). The number of excavations or workings that constitute a mine is to be determined upon the basis of the facts and circumstances of the particular case such as the nature and position of the mineral deposit or deposits, the method of mining the mineral, the location of the excavations or other workings in relation to the mineral deposit or deposits, and the topography of the area. The determination of the taxpayer as to the composition of a mine is to be accepted unless there is a clear and convincing basis for change in such determination.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA
Case No. 93-C-0036B

[File Stamped 1/14/93]

RHOADES OIL COMPANY,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

COMPLAINT FOR REFUND

1. Plaintiff is Rhoades Oil Company (the "Taxpayer"), an Delaware corporation with its principal place of business in Tulsa, Oklahoma.

2. Defendant is the United States of America.

3. Plaintiff brings this action against the United States of America for recovery of United States income taxes illegally and erroneously assessed against and collected from the Taxpayer. Taxpayer is an Oklahoma resident. Jurisdiction is conferred upon this Court by 28 U.S.C. § 1346(a)(1). Venue for this action is the Northern District of Oklahoma as provided by 28 U.S.C. § 1396.

4. Taxpayer is a working oil and gas company, and has been since it was founded in 1945. Taxpayer is presently the operator of approximately sixty oil and gas wells.

5. Taxpayer employs twenty people, including a full-

time geologist and a full-time land man. With the exception of a single employee who spends time monitoring the Taxpayer's invested funds, all of these employees are engaged in the Taxpayer's business of exploration for and exploitation of oil and gas reserves. Between 1988 and 1991, Taxpayer drilled thirteen wells. Taxpayer owns substantial percentages of sixty working interests, and is the operator of most of these wells.

6. Because drilling for oil and gas is an expensive and risky proposition, Taxpayer needs to build up and retain substantial cash reserves. These cash reserves allow Taxpayer to pay for drilling wells and absorb the losses of a dry hole.

7. In addition to drilling and operating wells, Taxpayer is the owner of both working and royalty interests in wells. A working interest is one that shares in the risk and cost of exploration and operation of a well. A royalty interest is one that receives a portion of gross revenues from oil and gas production, regardless of costs. Many of the royalty interests owned by Taxpayer were obtained in transactions whereby previously held working interests were converted into royalty interests.

8. On July 31, 1991, Taxpayer received a letter from the United States Internal Revenue Service ("IRS") notifying the Taxpayer of proposed federal income tax deficiencies under § 541 and § 542 of the Internal Revenue Code. These sections impose, under certain circumstances, an additional tax known as the personal holding company tax. The personal holding company tax is designed to attack "incorporated pocketbooks" in which an individual places liquid assets, and then uses the assets to pay for expenses.

The key characteristic of a personal holding company is the presence of substantial liquid assets that generate income, and very little actual operations. The Taxpayer is not such an incorporated pocketbook. It is an active oil and gas company, which has substantial assets only because it has been successful and profitable in its business through the years.

9. The notice of deficiency proposed assessments of additional tax as follows:

TAX YEAR	ADDITIONAL TAX
1988	$101,053.00
1989	$163,188.00
1990	$144,392.00

10. The reason that the IRS claimed these additional taxes were due was a change in the method by which the IRS determines whether Taxpayer was a personal holding company. In general, this test measures the income derived from investments against that derived from operations. This change was the deduction of "lifting costs" (the costs associated with producing oil and gas after a well has been drilled) from revenues generated by operations. If the treatment of lifting costs had not changed, Taxpayer would not have been found by the IRS to be a personal holding company, and the tax would not have applied. This change in the personal holding company test is contrary to the plain language of § 542 of the Internal Revenue Code, under which only depreciation, depletion, taxes, and interest are deducted from oil and gas revenues.

11. Taxpayer attempted to resolve the dispute with the IRS through a protest. This resulted in an admission by

the IRS of an error in its calculations. Accordingly, the amount of the proposed deficiency for tax year 1990 was reduced to $144,392.00. However, the IRS denied Taxpayer's protest as to the merits on the issue of whether the personal holding company tax should be assessed. Taxpayer executed and delivered to the IRS a Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Over Assessment, whereby Taxpayer accepted the correct assessment amounts as follows:

TAX YEAR	ADDITIONAL TAX
1988	$101,053.00
1989	$163,188.00
1990	$144,392.00

12. Taxpayer has consented to assessment of the corrected deficiencies, and has paid all additional tax and interest contained in such assessment.

13. On or about May 22, 1992, Taxpayer filed a Form 1120X - Amended U.S. Corporation Income Tax Return for each of the tax years in question, in which Taxpayer claimed refunds for all of the deficiencies assessed by the IRS against Taxpayer and paid by Taxpayer, together with all interest as allowed by law.

14. As of December 24, 1992, a date more than six (6) months after the filing of the Taxpayer's claims for refund, Taxpayer has received no notice that such claims have been approved or denied. Under § 6532 of the Internal Revenue Code, the Taxpayer's claims for refund are thus deemed to be denied.

15. The attempt by the IRS to deduct lifting costs in

calculating whether Taxpayer is a personal holding company was improper, and is contrary to the plain wording of the statute. Taxpayer is not a personal holding company, and the personal holding company taxes assessed against Taxpayer for 1988, 1989, and 1990 were illegally and improperly assessed and collected, and were contrary to law.

16. Taxpayer is the sole owner of the claims for refund described above, and has made no assignment of such claims.

WHEREFORE, Plaintiff Rhoades Oil Company prays that this Court enter judgment in its favor and against Defendant United States of America for taxes and interest paid in the amount of $503,689.00, plus interest as allowed by law.

DOERNER, STUART, SAUNDERS,
DANIEL & ANDERSON

By: /s/ Charles Greenough

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Rhoades Oil Company

IN THE UNITED STATES DISTRICT COURT FOR FOR THE NORTHERN DISTRICT OF OKLAHOMA
Case No. 93-C-0036B

[File Stamped 3/16/93]

RHOADES OIL COMPANY,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

ANSWER TO COMPLAINT FOR REFUND

The United States hereby answers the Complaint as follows:

1. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 1 of the Complaint.

2. The United States admits the allegations contained in paragraph 2 of the Complaint.

3. The United States avers that if jurisdiction exists, it exists by virtue of 28 U.S.C. Section 1346(a)(1), but denies that the federal income tax in issue were illegally or erroneously assessed or collected. The United States admits that venue is proper in the Northern District of Oklahoma.

4. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 4 of the Complaint.

5. The United States lacks knowledge sufficient to

form a belief as to the truth of the allegations contained in paragraph 5 of the Complaint.

6. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 6 of the Complaint.

7. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 7 of the Complaint.

8. The United States admits the allegations contained in the first sentence of paragraph 8, but avers that the remainder of paragraph 8 contains legal argument and conclusions requiring no response. To the extent the remaining allegations require a response, the United States lacks knowledge sufficient to form a belief as to the truth of those allegations.

9. The United States admits the allegations contained in paragraph 9 of the Complaint.

10. The United States avers that paragraph 10 contains legal argument and conclusions requiring no response. To the extent the allegations require a response, the United States lacks knowledge sufficient to form a belief as to the truth of those allegations.

11. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in the first and second sentence of paragraph 11 of the complaint, but admits the allegations contained in the remainder of paragraph 11.

12. The United States admits the allegations contained in paragraph 12 of the Complaint.

13. The United States admits that on June 1, 1992, plaintiff filed a Form 1120X - Amended U.S. Corporation

Income Tax Return for 1989 and 1990, but lacks knowledge sufficient to form a belief as to whether such form was filed with respect to 1988.

14. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 14 of the Complaint.

15. The United States denies the allegations contained in paragraph 15 of the Complaint.

16. The United States lacks knowledge sufficient to form a belief as to the truth of the allegations contained in paragraph 16 of the Complaint.

WHEREFORE, the United States prays that this Court dismiss the Complaint with prejudice, and the this Court grant such further relief as it deems proper.

TONY M. GRAHAM
United States Attorney

/s/ Christopher H. Grigorian
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96-5101

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

RHOADES OIL COMPANY,

Plaintiff - Appellee

v.

[File-Stamped
August 13, 1996]

UNITED STATES OF AMERICA,

Defendant - Appellant

ORAL ARGUMENT REQUESTED

ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF OKLAHOMA

APPELLEE'S SUPPLEMENTAL APPENDIX

JOHN B. TURNER
CHARLES GREENOUGH
STUART, BIOLCHINI,
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. . .

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OKLAHOMA
Case No. 93-C-0036-B

[COPY]

RHOADES OIL COMPANY,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

THE DEPOSITION OF JAMES M. DOWNS, taken on behalf of the Plaintiff, pursuant to the Federal Rules of Civil Procedure, this 10th day of May, 1994, commencing at the hour of 3:42 p.m., at the offices of Doerner, Stuart,

Saunders, Daniel, Anderson & Biolchini, 320 South Boston Avenue, Suite 500, Tulsa, Oklahoma, before Cathleen E. Marquardt, Certified Shorthand Reporter in and for the State of Oklahoma.

. . .

JAMES M. DOWNS,

after having been first duly sworn to testify the truth, the whole truth, and nothing but the truth, testified as follows:

DIRECT EXAMINATION

BY MR. GREENOUGH:

. . .

[PAGE 13, LINE 13]

Q In your expert opinion for companies that are involved solely in oil and gas exploration, do generally accepted accounting principles require classification of any costs as costs of goods sold?

A No, they do not.

Q No issued financial accounting standard requires that?

A No. That terminology has not been used as a cost description, if you will, in FAS 19 or 69.

Q Is that classification used in customary industry practice?

A For companies involved exclusively in exploration and production?

Q Correct.

A No, it is not.

Q For companies that are involved exclusively in oil and gas exploration, does FAS 19 specify a classification of the cost to operate and maintain wells and related equipment and to the other costs of operating and maintaining wells?

A Yes, it does.

Q And what is that?

A Operating expenses or lease operation expenses.

Q Does that classification include labor costs, repairs, maintenance, materials, supplies and fuels consumed, supplies utilized in operating wells, property taxes, insurance and severance taxes?

A Yes, it does.

Q So all of those items would be classified as production costs or lease operating expenses under generally accepted accounting principles?

A Yes, they are. Those terms are used interchangeably.

Q What is the reason behind that classification of costs?

MR. GRIGORIAN: Even though we're reserving objections, I would just like to state an objection to any testimony relating to reasoning behind the GAAP principles unless he's shown to have been involved in their promulgation and would know, or establish a foundation for where -- for why he knows what the reasons are.

Q (by Mr. Greenough) Based on your -- let me rephrase this question please. Based on your experience in the industry, do you have a belief as to the reason behind the classification that we just discussed?

A Yes, I do.
Q And what is that?
A That's the industry terminology for those classes of costs. The accounting followed what was standard terminology in the industry as related to those expenses.
Q For a company that's involved exclusively in oil an gas exploration and not in the business of refinery or chemically altering oil and gas products, is a classification of the items of costs we just discussed as costs of goods sold generally appropriate under generally acceptable accounting principles?
A Would it be generally appropriate to call those costs cost of goods sold:
Q Correct.
A No.

. . .

CROSS-EXAMINATION

BY MR. GRIGORIAN:

. . .

[PAGE 26, LINE 17]
Q So your opinion regarding the use of cost of goods sold in the oil and gas industry was that it would be an inappropriate form of classification on an income statement or a statement of operations. Is that what you stated earlier?
A That's correct.

Q When you refer -- when you use the term "inappropriate," what -- is it about the use of the phrase "cost of goods sold" that you find inappropriate?

A It's not descriptive in that it doesn't convey what the nature of those costs are. The nature of those costs are not cost of goods sold.

. . .

[PAGE 40, LINE 11]

. . .

Q I asked you earlier about trying to compare what a lifting cost is in an oil and gas company to what cost of goods sold are in a manufacturing process, and I believe it was your testimony that you can't compare them because, for one reason, you would incur lifting costs whether or not you sold any oil and gas; is that true? Is that one of the --

A That's one of the reasons.

Q Okay. Let me ask you, are there elements of cost of goods -- is there an element of cost of goods sold, whether or not you call it a cost of goods sold, but an expense incurred by the corporation which is contained in the cost of goods sold figure, but which would have otherwise been incurred whether or not the corporation, the manufacturing corporation, sold anything?

MR. GREENOUGH: I'll object as to vague. I don't understand that question at all.

Q (By Mr. Grigorian) Mr. Downs, do you understand the question?

A Not really, but I think I've already answered that question once.

Q Okay.

A I think you are asking it a different way, but a moment ago you asked me is there any -- if I took the scenario of -- if I would agree that lifting costs were somehow similar to cost of goods sold except they are called that by industry practice, and the answer is no. Lifting costs are a period cost for the operation of a property which would be incurred regardless of the level of production, regardless of the level of sales, and regardless of the level of revenues.

Cost of goods sold are the assigned costs of the inventory a company sold during the period, and there's no relationship between the two.

Q I understand that, but can you tell me what goes into a cost of goods sold?

A For a manufacturing company?

Q Yes.

A Well, why don't you ask me what goes into the cost of inventory because what goes into the cost of goods sold is merely an allocation of the inventory costs for the products you sold in a period. What goes into the cost of inventory depends upon your flow-of-cost assumption as to what accounting method you want to use, but it would include, in a manufacturing environment, direct labor, raw materials, supplies, and overhead, including depreciation.

If you didn't sell anything, you wouldn't have

any cost of goods sold that period. It would be zero. What you sell is merely an allocation of what you've accumulated as your inventory costs.

Lifting costs, on the other hand, they don't have any bearing to the level of sales. It's the costs you incur in the period to operate and maintain that property, which might include an allocation of support facilities for a group of properties which you would incur. Whether you produced and sold one barrel or a million barrels, you are going to incur some of those costs. That is a major difference, in my opinion.

Q Okay. The costs of inventory that you described as being elements of the cost of inventory, direct labor, overhead, supplies, cost of goods sold aside, are those expenses, would you agree, that are also often incurred regardless of whether or not the manufacturer sold any product?

A Irrespective of whether or not they are charged to expense and called cost of goods sold? There are costs -- there are costs in inventory for the cost of the products you manufactured during the period and prior periods. If you don't sell any of those, you don't incur any cost of goods sold.

Now, if you didn't manufacture anything either, you know, ignore the fact that you probably can only do that one year, but if you neither manufactured nor sold, there are costs that would show up as expenses in your financial statements, your statement of income. You'd have no revenues, you'd have no cost of goods sold. You could still have overhead, the administrative overhead called

general and administrative expenses. An oil company incurs general and administrative expenses, too, but in a manufacturing environment, the accounting rules and the tax rules would require you to capitalize a portion of those costs into inventory on an annual basis if you manufactured some products that period, but there's a distinction there. One relates to the capitalization in the inventory if they were manufactured. Cost of goods sold relates to what was the cost you've incurred for the products you sold that period. That's why it's, you know, a very descriptive term for refining and marketing and chemical operations, very descriptive.

[PAGE 45, LINE 4]

/S/ JAMES M. DOWNS
JAMES M. DOWNS

Sworn to and subscribed before me
this 19th day of May 1994.
/S/ CHERYL M. RANK
Notary Public
My Commission expires Nov. 17, 1996

(2)

Supreme Court, U.S.
FILED
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No. 97-511

In the Supreme Court of the United States

OCTOBER TERM, 1997

RHOADES OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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13 pp

QUESTION PRESENTED

Whether an oil and gas producer's "lifting costs" must be subtracted from its gross receipts to arrive at its "gross income" for purposes of determining liability for the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1986, 26 U.S.C. 541.

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In the Supreme Court of the United States

OCTOBER TERM, 1997

No. 97-511

RHOADES OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. A1-A3) and of the district court (Pet. App. A4-A25) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1997. The petition for a writ of certiorari was filed on September 17, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 541 of the Internal Revenue Code of 1986 (the Code), 26 U.S.C. 541, imposes a special tax on the "undistributed personal holding company income" of any "personal holding company." Under Section

542 of the Code, a corporation will generally be classified as a "personal holding company" if (i) more than half of its stock is held by five or fewer individuals, and (ii) 60 percent or more of its "adjusted ordinary gross income" is "personal holding company income." Section 543(b) defines "adjusted ordinary gross income" by providing for certain exclusions from, and adjustments to, "gross income," which is not further defined in the personal holding company provisions of the Code. Section 543(a) defines "personal holding company income" as the portion of "adjusted ordinary gross income" that is derived from certain typically passive sources, such as dividends, interest, rents, and royalties, rather than from the active conduct of a trade or business.

2. Petitioner is a closely-held corporation that derives part of its income from the business of locating and producing oil and gas, and part from passive investments such as bonds and publicly traded stocks. Pet. App. A5-A6. In computing its tax liability for 1988, 1989, and 1990, petitioner took the position that the "gross income" used as the starting point for the personal holding company calculations under Section 543(b) of the Code included its gross receipts from oil and gas sales, without reduction for the operating or "lifting" costs incurred in producing the oil and gas sold.[1] Pet. App. A8. On that assumption, petitioner's "personal holding company income" (primarily dividends and interest derived from its

---

[1] "Lifting" costs are those production expenses incurred after the completion of drilling but before removal of the oil or gas from the well site for sale or transportation, including labor, supplies, maintenance, and applicable overhead costs. Pet. App. A8 n.***.

stock and bond investments) amounted to less than 60% of its "adjusted ordinary gross income" for the years in question, and petitioner's returns reflected no liability for personal holding company tax. *Ibid.*

On audit, the Internal Revenue Service (Service) determined that, in arriving at its "gross income" for purposes of Section 543(b), petitioner was required to reduce its gross receipts from oil and gas sales by the associated lifting costs. Pet. App. A8-A9. On that basis, petitioner's "personal holding company income" amounted to considerably more than 60% of its "adjusted ordinary gross income" for each of the years at issue. See *id.* at A2, A9; Gov't C.A. App. 28-30. The Service therefore determined that petitioner was liable for personal holding company taxes totaling $408,633 for the three years in dispute. Pet. App. A7. After paying the amounts assessed, petitioner brought this suit in the district court seeking a refund on the ground that the Service had employed an improper measure of "gross income."

3. The district court granted summary judgment for petitioner. Pet. App. A4-A26. The court rejected the Service's reliance on *Laguna Royalty Co.* v. *Commissioner*, 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968), and on Rev. Rul. 60-344, 1960-2 C.B. 186, on the ground that both had involved tax years that pre-dated amendments made to the personal holding company provisions in 1964. Pet. App. A14-A21. The court further held (*id.* at A22-A24) that Section 61 of the Code, which defines gross income generally, and 26 C.F.R. 1.61-3, which deals with gross income derived from business, were best interpreted to treat all gross receipts from oil and gas sales as part of gross income, with lifting (and other)

costs deducted later in the computation of taxable income.

4. The court of appeals reversed. Pet. App. A1-A3. In a brief unpublished opinion, the court concluded that, after "carefully review[ing] the submissions of the parties," it was "persuaded that lifting costs are analogous to costs of goods sold and properly excluded in arriving at gross income, and hence adjusted gross ordinary income, for purposes of the personal holding company tax." *Id.* at A2. In support of that conclusion, the court observed (*ibid.*) that 26 C.F.R. 1.61-3(a) states the general rule that "gross income" is equal to total sales less the cost of goods sold. The court also noted that 26 C.F.R. 1.542-2, promulgated to implement the Code's personal holding company tax provisions, refers to Section 61 of the Code, and the regulations thereunder, for the definition of "gross income," and specifically points out that "gross income is not necessarily synonymous with gross receipts." Pet. App. A2-A3.

ARGUMENT

1. The court of appeals correctly held that an oil or gas producer's "lifting" costs must be subtracted from its gross sales receipts in order to determine its "gross income" for purposes of the personal holding company tax. That decision accords with the well established principle that a business taxpayer's "gross income" is equal to its gross receipts less its cost of goods sold. See, *e.g.*, 26 C.F.R. 1.61-3(a) ("In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold."); *Max Sobel Wholesale Liquors* v. *Commissioner*, 630 F.2d 670, 671 (9th Cir. 1980) ("The very definition of 'gross income' has been thought to man-

date the exclusion of certain amounts (*e.g.*, the cost of goods sold) from that figure, even in the absence of specific statutory authority for such exclusion."); *Woodside Acres, Inc.* v. *Commissioner*, 134 F.2d 793 (2d Cir. 1943), aff'g 46 B.T.A. 1124 (1942) (dairy's gross income determined by subtracting cost of producing milk from gross receipts); *Edenfield* v. *Commissioner*, 19 T.C. 13, 22 (1952) ("But it seems to us that [taxpayer] confuses gross receipts with gross income and obviously the two are not the same.").[2]

That principle applies in the context of the personal holding company tax. Section 1.542-2 of the Treasury Department's regulations, 26 C.F.R. 1.542-2, refers to Section 61 of the Code and the regulations thereunder, including 26 C.F.R. 1.61-3(a) (quoted above), for the definition of "gross income," and it specifically cautions that "[u]nder such provisions gross income is not necessarily synonymous with gross receipts." The Department has long interpreted those regulations as requiring an oil and gas producer to subtract its lifting costs from its gross receipts to arrive at gross income for purposes of determining liability for the personal holding company tax. Rev. Rul.

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[2] Petitioner argues at some length (Pet. 14-18) that the court of appeals erred by relying on 26 C.F.R. 1.61-3(a), which refers to "mining," in a case involving oil and gas production. The court of appeals did not, however, hold that production of oil or gas is "mining" for purposes of that regulation. The court correctly relied on Section 1.61-3(a) as an authoritative statement of the "general rule" that "gross income" means "total sales less the costs of goods sold"; it then held that "lifting costs are *analogous* to costs of goods sold * * * for purposes of the personal holding company tax," and it applied the general principle of Section 1.61-3(a) to this particular context by analogy. Pet. App. A2 (emphasis added).

60-344, 1960-2 C.B. 186; see *Laguna Royalty Co.* v. *Commissioner*, 406 F.2d 703 (5th Cir. 1969), aff'g 27 T.C.M. (CCH) 164 (1968). Unless the Department's interpretation of its own regulations is plainly inconsistent with the statute or the text of the regulations, it is entitled to "controlling weight." *Security Services, Inc.* v. *Kmart Corp.*, 511 U.S. 431, 436 n.2 (1994); see also, *e.g.*, *Auer* v. *Robbins*, 117 S. Ct. 905, 911 (1997); *Stinson* v. *United States*, 508 U.S. 36, 45 (1993); *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945).

As the court of appeals recognized (Pet. App. A3), the Service's position in this case "is supported by the regulations relied upon and is reasonable." The original purpose of the personal holding company tax was to discourage the use of closely held corporations for abusive purposes such as deriving and accumulating passive investment income (which might be taxed to the corporation at a rate lower than the marginal rate applicable to individual taxpayers). See generally, *e.g.*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.20 (6th ed. 1997). That purpose would be easily frustrated if a taxpayer could cause the corporation to fail the 60% test of Code Section 542(a)(1) by including within the corporate shell a business with large gross receipts, even though the true gross income from that business (*i.e.*, gross receipts less costs directly attributable to the product sold, but before deduction of general expenses such as sales and administrative costs) might represent a much smaller fraction of the corporation's overall gross income. In this case, for example, petitioner's 1989 corporate tax return reflects gross receipts from oil and gas working interests of $1,211,825, but a "gross profit" (receipts

less lifting costs and certain other allowable costs) of only $445,459. Gov't C.A. App. 19, 21; see also *id.* at 28. The same return reflects gross interest and dividend income of $1,264,893. *Id.* at 19. There is nothing surprising or improper about the Service's application of the personal holding company provisions to such a situation.

2. Petitioner argues (Pet. 6-7) that the court of appeals' summary order in this case conflicts with the principle, set out in various cases, that exclusions from gross income are to be narrowly construed. The cases petitioner cites, however, all presented questions concerning whether particular items of income were to be included in gross income, and therefore subjected to tax, at all. See *O'Gilvie* v. *United States*, 117 S.Ct. 452 (1996) (punitive damages); *Commissioner* v. *Schleier*, 515 U.S. 323 (1995) (damages for age discrimination); *United States* v. *Burke*, 504 U.S. 229 (1992) (backpay award); *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955) (punitive damages); *Commissioner* v. *Jacobson*, 336 U.S. 28 (1949) (discharge of indebtedness). This case, by contrast, involves only whether certain expenses are to be taken into account at the outset in computing "gross income," or later by deducting them from gross income in order to compute taxable income. The issue is therefore not what income will ultimately be subject to tax, but what measure of "gross income" is most appropriately used to compare petitioner's income from active business operations to its income from passive investments such as stocks and bonds for purposes of deciding whether or not to impose on petitioner the special personal holding

company tax. None of the cases petitioner cites speaks to that issue.[3]

Petitioner identifies no conflict on the issue actually presented in this case, and we are aware of none. To the contrary, the decision below joins both the Tax Court and the only other federal court of appeals that has considered the issue in rejecting the result for which petitioner contends. See Pet. App. A2; *Laguna Royalty Co.*, *supra*. In the absence of any conflict, the matter plainly does not warrant this Court's review.

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[3] Petitioner argues (Pet. 12-14) that the logic of the decision below would permit an oil or gas producer to subtract all of its ordinary business expenses from gross receipts to determine gross income, rather than deducting them from gross income, under Section 162 of the Code, in order to determine taxable income. That is not correct. The order below refers only to "lifting costs" (Pet. App. A2), a term with well understood contours—and limits—in the relevant industry. See, *e.g.*, *id.* at A8 n.*** (district court opinion); H. Williams & C. Meyers, *Oil and Gas Terms* 520 (1987); Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Standards No. 19: Financial Accounting and Reporting by Oil and Gas Producing Companies* ¶¶ 12 ("[P]roduction (lifting) costs become part of the cost of oil and gas produced."), 24-25 (defining "production costs (sometimes called lifting costs)"), reprinted in FASB, *Original Pronouncements* 226, 229-230 (1995/96 ed.). The decision in this case implies nothing about the tax treatment of other business expenses.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1997

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No. 97-511

Supreme Court, U.S.
FILED
DEC 1 1997
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1997

RHOADES OIL COMPANY

Petitioner,

v.

THE UNITED STATES OF AMERICA

Respondent.

ON A PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

PETITIONER'S REPLY BRIEF

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December 1, 1997

10 pp

QUESTION PRESENTED

Did the Tenth Circuit Court of Appeals violate this Court's rulings, reaffirmed most recently in *Commissioner v. Schleier*, 115 S.Ct. 2159 (1995) and *United States v. Burke*, 112 S.Ct. 1867 (1992), that exclusions from gross income are available only if specifically stated and that such exclusions must be narrowly construed, when the Tenth Circuit ruled that the lifting costs of an oil and gas business are excluded from its gross income because such lifting costs are analogous to costs of goods sold which are excluded from the gross income of a manufacturing, merchandising, or mining business under 26 C.F.R. §1.61-3(a)?

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Respondent.

PETITIONER'S REPLY BRIEF

ARGUMENT

The Brief of the United States in Opposition is an exercise in semantics. In its argument, the United States artfully manages to describe how lifting costs are not a part of the gross income of Rhoades Oil without ever using the words "exclude" or "exclusion." Instead, the United States uses "reduction," "reduce," "deducted," "subtracted," "subtract," and "taken into account at the outset." Only when required to quote the language of

the opinion of the Tenth Circuit below does the United States state the obvious - that the opinion below held that lifting costs are "properly excluded" from gross income by analogy to costs of goods sold under 26 C.F.R. §1.61-3(a). In doing so, the Tenth Circuit violated this Court's holdings that exclusions from gross income must be specific and must be narrowly construed. *Commissioner v. Schleier*, 115 S.Ct. 2159, 2163 (1995); *United States v. Burke*, 112 S.Ct. 1867, 1870, 1878 (SOUTER, J. Concurring at 1878) (1992); *Commissioner v. Glenshaw Glass Co.*, 75 S.Ct. 483, 475, 477-78 (1955); *Commissioner v. Jacobson*, 69 S.Ct. 358, 369 (1949).

At its heart, this case comes to a simple question: Should exclusions from gross income be narrowly construed in the rare case when doing so favors the taxpayer? The answer to this question is obvious. This Court's holdings on the construction of exclusions from gross income are the law in all cases, whether favorable to the taxpayer or to the government in any instance.

The argument that the United States is apparently trying to make is that *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson* somehow do not govern the issue of whether lifting costs are excluded from the gross income of Rhoades Oil Company because lifting costs aren't really "excluded" from gross income, but are instead "subtracted" from gross income, or are a "reduction" to gross income, or are "to be taken into account at the outset" in computing gross income.

These word games do not distinguish the holdings of this Court. Whether the word used is "exclude," "subtract," "reduce," or "deduct," *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson* stand for the principle that everything is in gross income unless there is something specific (which specific thing must be narrowly construed) that takes it out of gross income. And there simply is nothing that takes the lifting costs of an oil and gas produced out of gross income.

Although not directly stated, the United States also appears to suggest, when discussing the underlying rationale of the personal holding company tax provisions, that gross income for personal holding company tax purposes is somehow different than gross income as interpreted in *Schleier*, *Burke*, *Glenshaw Glass Co.*, and *Jacobson*. The penultimate paragraph of the Brief in Opposition states that the issue is "what measure of 'gross income' is most appropriately used" in calculating personal holding company taxes. The flaw in this argument is that there is only one measure of gross income. That measure is 26 U.S.C. §61 and this Court's cases interpreting it.

The inference that gross income is somehow different for personal holding company tax purposes is also directly inconsistent with the main argument of the United States, which relies on the fact that the outdated regulations issued under the personal holding company tax provisions refer to 26 U.S.C. §61 and its regulations for the definition of gross income. Indeed, the entire

argument of the United States hinges on the analogy to 26 C.F.R. §1.61-3(a) made in Revenue Ruling 60-344. That regulation, of course, concerns the definition of gross income under 26 U.S.C. §61, which is the same definition interpreted by this Court in *Glenshaw Glass*, *Jacobson*, *Schleier*, and *Burke* to have been intended by Congress to be as broad and inclusive as possible, with the necessary corollary that exclusions must be specific and must be interpreted as narrowly as possible.

Moreover, the United States fails to point out that the purpose which it claims underlies personal holding company taxes, to discourage abusive use of closely held corporations where income is taxed at lower corporate tax rates instead of higher individual tax rates, was obliterated in 1986 when the highest marginal tax rates for individuals were lowered to be nearly identical to the corporate tax rate. Today, personal holding company taxes are little more than a double tax trap for the unwary. This trap should not be further extended by the analogous extension of 26 C.F.R. §1.61-3(a) made by the Tenth Circuit below.

The argument by the United States that Revenue Ruling 60-344 should be accorded controlling weight as an interpretation by the Internal Revenue Service of its own regulations that is not plainly inconsistent with the language of the regulation is easily exposed. Revenue Ruling 60-344 does not <u>interpret</u> the meaning of 26 C.F.R. §1.61-3(a) at all. Instead, Revenue Ruling 60-344 makes the same mistaken <u>analogy</u> that the Tenth

Circuit did - that lifting costs should be excluded from gross income because they are similar to costs of goods sold which are excluded from gross income under 26 C.F.R. §1.61-3(a). If, as the United States wishes, that analogy is characterized as an interpretation, then that interpretation is in fact plainly inconsistent with the language of 26 C.F.R. §1.61-3(a) because "mining" is not "oil and gas production" and "lifting costs" are not "costs of goods sold." Either way, the argument of the United States does not withstand any degree of scrutiny.

This Court need not decide whether there is, as claimed by the United States, a general rule that costs of goods sold are excluded from gross receipts to determine gross income apart from 26 C.F.R. §1.61-3(a). Even if there is such a rule, it simply does not apply to this case, because lifting costs are not costs of goods sold, as established by the record below. A-69.

RELIEF REQUESTED AND CONCLUSION

Petitioner asks this Court to grant certiorari to correct the Tenth Circuit's error. Exclusions from gross income must be narrowly construed in all cases, not just in cases where to do so favors the government.

Respectfully submitted,

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